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In The Supreme Court of the United States

DURA PHARMACEUTICALS, INC., et al.,

Petitioners,

v.

MICHAEL BROUDO, et al.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF AMICUS CURIAE THE REGENTS OF THE UNIVERSITY OF CALIFORNIA IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICUS CURIAE[1]

Article IX, section 9 of the California Constitution grants The Regents of the University of California ("The Regents") "full powers of organization and government" over the University of California. As fiduciary for the University's pension and endowment funds, which invest approximately $53 billion in publicly traded U.S. securities, The Regents has a strong interest in the continued ability of our nation's securities laws to promote transparency and integrity of the securities markets. In February 2002, the United States District Court for the Southern District of Texas appointed The Regents to be lead plaintiff representing a class of investors who purchased securities of the Enron Corporation. *Newby v. Enron Corp. (In re Enron Corp. Securities Litigation)*, 206 F.R.D. 427 (S.D. Tex. 2002). The Regents' experience as lead plaintiff in *Enron* will assist the Court in evaluating the implications of its decision for cases involving complex fraudulent schemes.

SUMMARY OF ARGUMENT

Petitioners propose a false choice between two extreme views of loss causation. They claim that the Ninth Circuit has permitted securities fraud plaintiffs to recover based on a mere showing that defendants' fraud caused

[1] No counsel for any party authored this brief in whole or in part. No person or entity other than The Regents has made a monetary contribution to the preparation or submission of the brief. Petitioners and respondents have consented to the filing of this brief. Their letters of consent have been filed with the Clerk of the Court.

price inflation at the time plaintiffs bought securities.[2] They posit as the only alternative to this approach an inflexible rule under which plaintiffs must demonstrate that the price of the securities fell in response to disclosure of each defendant's fraud. The proper loss causation rule in a price-inflation case such as this one falls between these extremes and requires plaintiffs to prove that: (1) defendants' fraud caused plaintiffs to pay an inflated purchase price for the securities at issue; and (2) plaintiffs did not recoup all of that price inflation through sale of the securities. Plaintiffs need not demonstrate that a disclosure of the fraud led to a decline in the market price of the security to make either showing.

For over a century, this Court has recognized that the "loss" for which plaintiffs seek to recover damages in price manipulation cases is their "out-of-pocket" loss; that is, the difference between the true value of the securities and the fraud-influenced transaction price. Plaintiffs' out-of-pocket loss is mitigated to the extent that plaintiffs both buy and sell securities at a fraud-inflated price. Plaintiffs must therefore show that they did not recoup their loss by selling into the market at an equally inflated price. But this does not mean that plaintiffs can prove loss causation *only* by proving that a corrective disclosure of the fraud was followed by a stock price drop. "There is . . . more than one way to demonstrate the causal connection." *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

[2] This is a caricature of Ninth Circuit precedent, since that court has made clear that plaintiffs must also demonstrate that inflation was reduced or eliminated prior to their sale. *See Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 & n.4 (9th Cir. 1987).

Petitioners' rigid rule is based on twin errors. *First*, it confuses the concepts of "value" (the price that the market would set based on truthful information) and "price" (the price that the market sets in fact) with "artificial inflation" (the difference between value and price). Proper analysis of plaintiffs' loss focuses on *artificial inflation*: if fraud-caused price inflation plaintiffs pay when they purchase a security cannot be fully recovered through sale, plaintiffs have suffered a loss caused by defendants' fraud. Changes in the amount of artificial inflation may be independent of price movement; as the United States demonstrates, artificial inflation may be reduced or eliminated even when the stock price *increases*. *Second*, petitioners and some lower courts have incorrectly assumed that the *only* means by which artificial inflation can be eliminated from the market price of a security is through disclosure of the truth. In fact, many other factors, including both company-specific and market-wide developments, can reduce artificial inflation. Where artificial inflation is reduced prior to plaintiffs' sale, regardless of the reason, plaintiffs incur a fraud-caused loss because they cannot recoup the full amount of their fraud-caused overpayment.

The Enron debacle provides a graphic demonstration of the perverse consequences that would result from application of the loss causation rule petitioners propose. The *Enron* defendants are alleged to have engaged in a wide-ranging, long-lasting, and diabolically complicated fraud – effectively the largest Ponzi scheme in American corporate history – causing millions of investors to overpay for Enron's nearly worthless securities. When the scheme finally collapsed and Enron went bankrupt, these investors suffered terrible losses. Yet, employing petitioners' loss causation analysis, various defendants contend that

they are immune from liability because their role in the scheme was not disclosed until after Enron's collapse, when disclosure could have no further price effect. That argument reveals how petitioners' one-size-fits-all corrective-disclosure requirement creates a "disclosure lottery" in which those defendants that are most successful in hiding their role and least forthcoming in disclosing the fraud are immunized from liability. Such a rule furthers no policy of the securities laws and undermines the ability of deserving plaintiffs to recover from culpable defendants.

ARGUMENT

I. PROOF OF LOSS CAUSATION REQUIRES NEITHER A CORRECTIVE DISCLOSURE OF THE FRAUD NOR A FRAUD-CAUSED DECLINE IN THE STOCK PRICE.

A. Plaintiffs' Loss Is the Unrecouped Inflation that Defendants' Fraud Added to the Purchase Price of Securities.

Statutory interpretation begins with the language of the statute. *See Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 24 (1977). The 1995 Private Securities Litigation Reform Act ("PSLRA") added a "loss causation" section to the 1934 Securities Act, which provides: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). Nothing in this text requires plaintiffs to show that defendants' fraud caused a decline in investment price, nor does it define or limit the nature of the loss for which plaintiffs can claim damages. It provides only that

plaintiffs bear the burden of proving that defendants' fraud caused whatever loss plaintiffs claim.

A central error in petitioners' and some lower courts' loss causation analyses is their failure to remain clear about the nature of plaintiffs' claimed loss. Petitioners repeatedly refer to plaintiffs' "loss" as a decline in the value of their stock. *See, e.g.*, Pet. Br. at 4-5, 11. In fact, this Court and lower courts have recognized for over a century that the primary measure of injury when a plaintiff is fraudulently induced to purchase or sell securities is the plaintiff's "out of pocket" loss; that is, the difference between the transaction price and the true value of the security at the time of the transaction.[3] *E.g.*, *Randall v. Loftsgaarden*, 478 U.S. 647, 661-62 (1986) ("[O]rdinarily 'the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct. . . . '" *quoting Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972)); *Sigafus v. Porter*, 179 U.S. 116, 123 (1900) ("The true measure of the damages suffered by one who is fraudulently induced to make a contract of sale, purchase, or exchange of property is the difference between the actual value of that which he parts with and the actual value of that which he receives under the contract."); *Smith v. Bolles*, 132 U.S. 125, 130-31 (1889) (applying same rule to stock fraud case); *Sowell v. Butcher & Singer, Inc.*, 929 F.2d 289, 297 (3d Cir. 1991) (In 10b-5 cases "a plaintiff's damages are most commonly calculated as the difference

[3] "True value" is merely the price that the market would have set absent the fraud. *See Sowell v. Butcher & Singer, Inc.*, 929 F.2d 289, 297-98 (3d Cir. 1991); *see also Basic*, 485 U.S. at 246.

between the price paid for a security and the security's 'true value'."); *Alley v. Miramon*, 614 F.2d 1372, 1387 (5th Cir. 1980) (same). Even courts that have imposed a "disclosure/price correction" rule have – at least initially – accepted out-of-pocket damages as the proper measure of plaintiffs' loss. *E.g., Semerenko v. Cendant Corp.*, 223 F.3d 165, 184-85 (3d Cir. 2000); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 n.5 (11th Cir. 1997).[4] These decisions recognize the simple point that "[p]aying more for something than it is worth is damaging." *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

Application of the out-of-pocket rule is consistent with the purpose of the 1934 Act, which is not to guard against stock price declines, but "to protect investors against manipulation of stock prices." *Lampf, Pleva, Lipkin, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360-61 (1991); *Basic,* 485 U.S. at 230. It is also consistent with the legislative history of section 78u-4(b)(4) in which Congress noted that loss causation may be shown "[f]or example" by proving "that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission." H.R. Conf. Rep. No. 369, 104th Cong., 2d Sess. 41 (1995).

Unlike petitioners, the United States recognizes that plaintiffs' loss arises from artificial inflation of the plaintiffs' purchase price. The United States, along with many lower courts, also correctly notes that plaintiffs' loss is mitigated to the extent that inflation remains reflected in

[4] Yet *Semerenko* and *Koger* err by later inconsistently characterizing plaintiffs' loss as a decline in "value" or "price." *Semerenko.*, 223 F.3d at 185; *Koger Properties, Inc.*, 116 F.3d at 1448.

the stock price at the time the defrauded investor sells. Brief of U.S. at 15 et seq. Therefore, if the amount of fraud-induced inflation at the time a plaintiff sells equals the amount of inflation at the time he bought, he has suffered no damage at all because he is in exactly the same net position he would have been in without the fraud. Brief of U.S. at 21. Conversely, if the amount of artificial inflation has been reduced between the time of plaintiff's purchase and sale, the plaintiff has necessarily suffered damage caused by the fraud because he has made a fraud-induced "overpayment" that he is unable to fully recoup.

To illustrate these points, assume an investor purchases a stock worth $8 at a fraud-inflated price of $10. If artificial inflation remains $2 when the investor sells, whether the stock price rises or falls, he has suffered no loss because he is able to recover the $2 and remains in the same net position he would have been but for the fraud. If, on the other hand, all inflation is eliminated from the stock price, but its true value remains constant and the investor sells for $8, he has plainly suffered a $2 loss caused by the fraud. Alternatively, if inflation is eliminated but the true value had increased to $9, the investor would still be "out of pocket" $2, since, in the absence of the fraud he would have paid only $8 and reaped a $1 profit instead of a $1 loss. Similarly, if inflation is eliminated and the true value declines to zero, the investor's fraud-caused loss remains $2, since absent the fraud he would have lost $8, not $10.

As the United States also demonstrates, changes in the amount of artificial inflation need not be accompanied by movement of the stock price, and the presence of a true out-of-pocket loss is not dependent on a drop in the price of

plaintiffs' stock. Brief of U.S. at 19-20. For example, disclosures that eliminate artificial inflation might be offset by a contemporaneous public announcement of positive news, and therefore elimination of inflation might be accompanied by a net *increase* in price. *Id.* Similarly, an *increase* in the amount of artificial inflation may occur without an increase in the price of the stock, as when a company fails to make a required disclosure of material negative news that would have caused the price of its stock to decline. The introduction of artificial inflation into the price of a stock may even be accompanied by a price *decrease*, as when the perpetrators announce false positive news in an attempt to soften the price decline caused by contemporaneous publication of some negative development. Like petitioners, some courts have incorrectly asserted that plaintiffs must show that the stock price changed in order to prove that the fraud influenced the transaction price. *E.g.*, *Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657, 662 (5th Cir. 2004) (plaintiffs must demonstrate stock price "was actually affected by the allegedly false statements, either by showing an increase in price following the allegedly false positive statements or a corresponding decrease in price following the revelation of the misleading nature of these statements").[5] "Litigants and courts" who have suggested that price changes must accompany changes in artificial inflation "are mistaken." Brief of U.S. at 19. The correct

[5] This incorrect conclusion has led courts to all sorts of corollary errors. In *Greenberg*, for example, the Fifth Circuit also held that "confirmatory" statements could not be actionable because they do not affect the stock price. 364 F.3d at 663. This ignores the possibility that a statement that confirms rather than contradicts a misrepresentation may extend the period during which the stock price is artificially inflated, thereby injuring additional investors.

inquiry is whether artificial inflation was caused by defendants' fraud and whether that inflation was reduced prior to plaintiffs' sale.

Therefore, before recovering damages for fraud under the 1934 Act, each plaintiff must show that artificial inflation was reduced or eliminated prior to plaintiff's sale of the investment. This requirement falls at the intersection of loss causation and proof of damages, and it is immaterial of which inquiry it is considered a part. Nevertheless, it is worth noting that, in practice, analyses of the amount of damages in securities litigation typically incorporate any mitigating sale price inflation. Damages are usually proven by expert studies that seek to construct a "value line" charting the true value of the securities over time, thereby indicating the amount of inflation – that is, the difference between the "value line" and the actual market price – on each day of the relevant period.[6] Damages for each plaintiff are calculated by subtracting the amount of inflation on the date of plaintiff's sale from inflation on the

[6] Several *amici* argue that specific expert methodologies are the only valid means to quantify plaintiffs' damages. *See, e.g.*, Brief of Securities Industry and Bond Market Associations at 9-10 (backcasting event study analysis); Brief of Broadcom Corp. at 10 (dollar versus percentage decline measure of loss). This case – which is currently only at the pleading stage and in which conflicting expert methodologies have not even been presented to, much less ruled on by, the trial court – does not require this Court to address that issue. It is sufficient to note that determination of an appropriate damages methodology is a complex question, the correct answer to which may vary with the circumstances of each case. *See, e.g.*, Crew, Goshtigian, Moore & Sarin, "Securities Act Violations: Estimation of Damages," in Litigation Services Handbook, The Role of The Financial Expert at 17.14 (3rd Edition, 2001) Weil, Wagner & Frank, eds.; Tabak & Okongwu, "Inflation Methodologies in Securities Fraud Cases: Theory and Practice," NERA Working Paper at 3-4 (July 2002).

date of plaintiff's purchase. *See, e.g., In re Cendant Corp. Securities Litig.*, 109 F.Supp.2d 235, 264 (D.N.J. 2000), *aff'd*, 264 F.3d 201 (3d Cir. 2001); *In re California Micro Devices Securities Litig.*, 965 F.Supp. 1327, 1333 (N.D. Cal. 1997); Cornell & Morgan, "Using Finance Theory to Measure Damages in Fraud on the Market Cases," 37 U.C.L.A. L. Rev. 883, 886 (1990). Under the type of damage analyses already routinely employed, no plaintiff recovers more than his actual damages.

B. Proof that Defendants' Fraud Caused Unrecouped Inflation Does Not Require a Showing that Disclosure Resulted in a Price Drop.

Thus, the conceptual framework that the United States proposes for analysis of loss causation is the correct one: plaintiffs must demonstrate, not that disclosure of defendants' fraud caused a decline in stock price, but that defendants' fraud caused inflation in their purchase price and that the inflation was reduced or eliminated prior to plaintiffs' sale. Nevertheless, the United States, like petitioners and some lower courts, errs by assuming that artificial inflation may be reduced or eliminated from the stock price *only* through disclosure of the fraud (either through words or "by events"). *See* Brief of U.S. at 7; *see also* Pet. Br. at 13.[7] Causation must be determined on the basis of facts, not blanket assumptions. *See Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382 n.5 (1970) (rejecting

[7] An associated error is the position of some courts that, where disclosure has not resulted in a price change, the alleged fraud must never have influenced the stock price in the first place. *E.g., Greenberg*, 364 F.3d at 662.

causation analysis based on "dubious" implicit assumption). Elimination of artificial inflation means simply that the effectiveness of the fraud ceases in that it no longer influences the stock price; reduction of inflation means that the fraud has lost some, but not all, of its effectiveness. The effect of a fraud can be reduced or eliminated by circumstances other than disclosure of the truth. *See Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345 (9th Cir. 1977) (Sneed, J., concurring); *In re Initial Public Offering Litig.*, 297 F.Supp.2d 668, 673 (S.D.N.Y. 2003) ("*IPO Litig.*"). Some examples show how:

1. Artificial inflation may dissipate from the price of a security through the passage of time. "[O]rdinary market forces affect the rate of artificial inflation" because in some circumstances "the normal functioning of the securities market causes the inflationary effect to dissipate over time." *IPO Litig.*, 297 F.Supp.2d at 673. In evaluating a company's current condition and future prospects, the market will pay more attention to its most recent results. Therefore, if a corporation misstates quarterly earnings to meet expectations, the inflationary impact of that misstatement is likely to dissipate as increasingly distant historical earnings numbers become less and less important. *See id.* at 674 n.29 ("In some cases, however, the importance of misstatements may diminish over time, and inflationary effect may diminish (or disappear entirely) with it."). While disclosure of the misstatement immediately after it was made may have resulted in a dramatic drop in the stock price, disclosure may have little or no impact if the perpetrators are able to conceal the fraud long enough. Yet investors who bought the stock immediately after the misstatement and held it have been injured: compared to their position had they purchased at

true value, they are "out of pocket" the amount of the inflation, which they cannot recoup by selling. Whether the stock rose or fell in the interim, their investment gain has been reduced, or loss increased, by the fraud. The perpetrators' success at concealment (assuming the statutory period of repose has not expired) should not immunize them from liability.

2. If the market price of a security drops to zero, whatever the cause, it is necessarily true that all artificial inflation has been eliminated from the price. Subsequent disclosure of the fraud can cause no further drop in price. While investors' out-of-pocket loss does not include that portion of the purchase price representing the true value of the stock at the time of their purchase, investors should recover the amount of inflation they paid above that true value – the part of their loss that was caused by the defendants' fraud – whatever the cause of the company's decline. Compared to the position investors would have been in, they are "out of pocket" the amount of inflation they paid at the time of their purchase. Put another way, the amount of their loss in the bankruptcy has been increased by the fraud.

3. Company-specific developments may eliminate artificial inflation. If, for example, a company's stock price is inflated because of false claims it has made about the capabilities of an anticipated product, investors who purchase the stock are injured by paying too much. If the company then announces that it is abandoning the entire segment of its business that includes the new product, any artificial inflation that the false product claims contributed to the stock will be removed since the now-abandoned

product will become irrelevant to the market's evaluation of the company.[8] Although there has been no disclosure of the fraud, investors who purchased the company's stock at the inflated price have been damaged by paying an excessive price they cannot now recoup through sale. Because the market has already discounted the inflationary impact of the fraud, its subsequent disclosure will not affect share price.

4. Market-wide developments may reduce artificial inflation by reducing the importance of fraudulent misstatements. In his concurrence in *Green v. Occidental Petroleum*, 541 F.2d at 1345, Judge Sneed rejected the assumption that the amount of artificial inflation (the "spread" between the "price" and "value" lines) would necessarily remain constant prior to disclosure of the fraud and offered the following example:

> [A] false representation that the corporation has discovered oil will increase in value if the price of oil goes up subsequent to the misrepresentation. Expressed in terms of price and value lines, the spread between the lines increases causing the lines to diverge. A decline in the price of oil, on the other hand, will reduce the value of the misrepresentation and cause the lines to converge.

Id. (footnotes omitted). In this example, if the price of oil declines, and the value of the misrepresentation falls, some artificial inflation has been removed from the stock price. Plaintiffs who sell at that point will suffer a loss

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[8] Nevertheless, if the market believed that – despite its hopes that sales of the new product would mitigate the loss – the overall segment would lose money in the future, the announcement that eliminated the price inflation might result in an *increase* in the stock price.

because not all of the price inflation they paid when they bought the stock will be recaptured through the sale.

As these examples illustrate, the amount of inflation at the time of plaintiffs' purchase and sale can be determined only in light of all the facts peculiar to each case. Yet the rule urged by petitioners would permit courts to look *only* at whether there was a disclosure of the fraud and its impact on price. "Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive." *Basic*, 485 U.S. at 236. Petitioners' proposed rule should therefore be rejected.

The examples above also belie the United States's assertion that the fraud on the market theory implies that artificial inflation must remain in the stock price prior to disclosure of the fraud. *See* Brief of U.S. at 21. The fraud-on-the-market theory posits that efficient markets will react quickly to new material information, *Basic*, 485 U.S. at 246 n.24, but it does not assert that the materiality, and thus the price impact, of any particular piece of information (or misinformation) must remain constant regardless of the passage of time and changing circumstances. On the contrary, since the market responds to *all* available information, *id.* at 246, the theory suggests that, as circumstances change and new information becomes available, the importance that the market places on the fraudulent information may also change. Disclosure of a company's falsification of quarterly earnings that might have been quite material at the time of the earnings announcement will be far less so years later when subsequent performance information is available. A significant fraud may become utterly immaterial to the market's evaluation of a company after the market learns the company is bankrupt.

Material information may become irrelevant if a company's business changes significantly. The importance of information will vary with external market conditions. The market's reaction to fraud disclosure will accurately reflect the materiality of the fraudulent information *at the time of the disclosure,* but it may say little about the importance of the fraud *at the time of plaintiff's purchase* (and therefore little about the dollar amount of artificial inflation the fraud added to plaintiffs' purchase price). Full and unambiguous disclosure of a fraud allows us to presume that artificial inflation has been eliminated, but absence of disclosure does not allow us to presume that it has not.

Similarly flawed is the argument that when fraud-induced inflation is reduced other than by disclosure there has been a "superseding cause" of plaintiffs' loss that relieves the perpetrator of liability. *See* Restatement 2d Torts § 440. First, where the nature of the harm is a foreseeable result of defendants' wrongful act, the fact that it is brought about by some intervening force does not relieve the perpetrator of liability. *See* Restatement 2d Torts § 548A ("A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance."); *see also* Restatement 2d of Torts, §§ 442A & 442B (where "actor creates or increases the risk of a particular harm . . . the fact that the harm is brought about through the intervention of another force does not relieve the actor of liability. . . ."); 1 D. Dobbs, The Law of Torts § 189 at 466 (2001) (where the "general kind of harm" is foreseeable, defendant "is not normally relieved of liability merely because the manner

of injury . . . [was] unforeseeable").[9] Since nothing lasts forever, it is always foreseeable that defendants' frauds will someday lose their effectiveness thereby reducing or eliminating inflation from the stock price. Therefore, it is reasonable to expect, if not inevitable, that some investors will be left holding the stock when the frauds lose their effectiveness and be unable to recoup their overpayment through sale. The frauds' eventual loss of effectiveness, whether resulting from disclosure or something else, is not a "superseding" cause of injury separate from the fraud, but a natural and foreseeable consequence of the frauds themselves. Second, since the plaintiffs' "loss" is their fraud-induced overpayment, plaintiffs' inability to recoup that overpayment through sale means only that a third party – another buyer – has not mitigated that loss by paying plaintiffs an inflated price for the stock. The failure of a third party to make good plaintiffs' injury is not a "superseding cause" of their loss. *See* Restatement 2d Torts § 452 (failure of third party to prevent harm threatened by

[9] Citations to Restatement § 548A by petitioners (Pet. Br. at 32 n.13 and 33) and the United States (Brief of US at 18) excise the important concept of foreseeablity. *See* Restatement 2d Torts § 548A, comment b. Although § 548A does not expressly analyze causation in the fraud-on-the-market context, it strongly supports The Regents' position. Illustration 2 states, for example, that where the investor "suffers a pecuniary loss" from insolvency that is "greater than that which would have resulted" absent the fraud, the perpetrator "is subject to liability . . . for the additional pecuniary loss." This is exactly the circumstance suggested by example number 2 above, and by the *Enron* facts discussed below, in which investors lost more than they would absent the fraud because of the inflated price they paid. In contrast, the comments and examples that petitioners and *amici* cite stand only for the proposition that when a non-fraud related event causes a decrease in the *true value* of an investment (as when a corporation's leading officers die or a court invalidates municipal bonds), fraud is not the legal cause of that loss.

defendant's conduct "is not a superseding cause of such harm").

Finally, a disclosure requirement is arbitrary not only because it is unnecessary to demonstrate an out-of-pocket loss, but also because it is unconnected, and even contrary, to the goals of the securities laws. Rather than conditioning liability on the fraudulent conduct that those laws seek to deter or on the injury such conduct causes investors, petitioners' rule hinges liability on the existence of circumstances the law should seek to encourage: disclosure that ends the fraud's effect on the market. Perversely, under petitioner's rule it is the defendant who *has* timely disclosed the fraud who becomes liable, while the defendant who hides his fraud long enough is immunized. Such a requirement will bar plaintiffs from recovering the excess they paid as a result of defendants' price manipulation but cannot recover through sale, permit culpable defendants to avoid liability, and affirmatively discourage corrective disclosure.[10]

[10] This Court should reject the contention of petitioners and *amici* that adoption of an arbitrary "disclosure/price-drop" requirement is necessary to prevent introduction of speculative expert damage analyses and the extortionate settlements that would supposedly result. The PSLRA specifically addressed the settlement concern, *see, e.g.*, H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 37-38 (1995), and there is strong evidence that the Act has successfully reduced the problem of nuisance suits. *See* Choi, "Do the Merits Matter Less After the Private Litigation Reform Act?," University of California, Berkeley Law School Public Law & Legal Theory Research Paper No. 558285 at 1-6 (June 23, 2004) (available at http://ssrn.com/abstract=558285). Similarly, this Court has provided district courts with standards to ensure that only reliable expert analysis is admitted into evidence and has expressed confidence "that federal judges possess the capacity to undertake this review." *Daubert v. Merrill Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 593 (1993).

II. A CORRECTIVE DISCLOSURE REQUIREMENT WOULD UNDERMINE IMPORTANT INVESTOR PROTECTIONS IN CASES INVOLVING COMPLEX FRAUDULENT SCHEMES SUCH AS THE ENRON CORPORATION SECURITIES FRAUD CASE.

A. The Enron Scheme.

The plaintiffs' allegations in *In re Enron Corp. Securities Litigation*, describe perhaps the most far-reaching, complex, and long-lasting fraudulent scheme in our nation's corporate history. Many of the roots of the scheme lie in Enron's overly aggressive embrace of mark-to-market accounting, under which the company cannibalized future earnings by booking and reporting all profit that it *projected* would be earned from transactions throughout their lifetime as *actual* profit in the quarter in which the deal closed. *See In re Enron Corp. Securities, Derivative & ERISA Litig.*, 235 F.Supp.2d 549, 622-23 (S.D. Tex. 2002). Because this form of accounting amplified present results at the expense of the future, to maintain the appearance of robust growth Enron was required each quarter to close an ever greater number of transactions that it could "mark-to-market." *Id.* at 623 n.60. This imperative fostered a culture of promiscuous deal-making in which the quality of transactions and their profitable implementation were secondary to simply getting the deal done, and Enron collected a growing portfolio of poor investments. *Id.* Enron's addiction to mark-to-market accounting also created a "disconnect" between its growing reported profits (which were based on projected future results) and actual current cash flows and operational revenue. These conditions, if they became obvious, threatened to undermine Enron's stock price and credit rating,

maintenance of which was essential to the survival of the company's deal-making operation. *See id.* at 631.

Using outsized fees as an inducement, Enron was able to enlist many of the world's largest financial institutions to help it engineer a complex web of so-called "SPE" transactions that enabled the company to conceal these problems and to report ever-increasing profits. *Id.* at 638. As described by the district court:

> The consolidated complaint sets out an elaborate scheme of off-the-books, illicit partnerships, secretly controlled by Enron and established at times critical for requisite financial disclosures by Enron in order to conceal its actual financial status. These Enron-controlled entities typically would buy troubled assets from Enron, which Enron would have had difficulty selling in an arm's length transaction to an independent entity and which otherwise would have to be reported on Enron's balance sheet, by means of sham swaps, hedges, and transfers, to record phony profits and conceal debt on Enron's balance sheet.

Id. at 613-14; *see also id.* at 638. In addition, Enron and its banks engaged in numerous circular "pre-pay" commodities contracts designed to create a false impression of increased cash flow and to hide the company's mounting debt burden. In these transactions, Enron, a financial institution, and a sham entity controlled by the financial institution entered into a series of circular future commodities sales. When the reciprocal trades were offset, the economic effect of the transaction was a loan from the financial institution to Enron. By improperly characterizing them as commodities transactions, Enron was able to report the loan proceeds as cash flow from operations,

thereby massively overstating Enron's operating cash flow and understating its bank debt. *Id.* at 627-29.

Enron's financial misstatements and apparent robust growth led to a soaring stock price, rising from roughly $18 in August 1997 and peaking at over $90 per share in August 2000. Despite their inside knowledge of Enron's phony financial statements, "[t]he banks were central players in inflating and supporting the price of Enron stock through issuance of glowing research reports with misleading information about Enron." *Id.* at 638. But the deception could last only so long. Although there was no disclosure of fraudulent transactions, throughout the first three quarters of 2001, as some market watchers raised public concerns about Enron and events at the company suggested that all might not be well, Enron's share price began to erode. *E.g.*, *id.* at 631. For example, a March 5, 2001 article in *Fortune* was titled: "Is Enron Overpriced? It's in a bunch of complex businesses. Its financial statements are nearly impenetrable. So why is Enron trading at such a huge multiple?" In July 2001, fearing the impending collapse, Enron's CEO Jeffery Skilling unexpectedly announced his resignation. *Id.* at 634. Enron and many of the financial institutions that were heavily involved in the scheme reacted with a furious public campaign to dismiss doubts and maintain Enron's stock price. For example, after Skilling's announcement, Enron and its bankers sought to reassure the market that there was "nothing to disclose" and that Enron's "future had never been brighter." *Id.* at 634-35. Nevertheless, many of the financial institutions began to recognize that the scheme could not be maintained indefinitely, and so attempted to push their exposure to Enron onto other, unsuspecting parties. *Id.* at 632.

Within a few months, the Ponzi scheme started to collapse. As Enron's stock price dropped, many of the SPE deals, which were supported and capitalized by Enron's own stock, began to fail and had to be restructured. *See id.* at 626, 631, 633-34, 636. When restructuring became impossible, Enron was forced to consolidate off-the-books entities and transactions into its own financial statements and to restate prior financial reports, resulting in a cascade of negative partial disclosures that quickly brought down the house of cards. On October 16, 2001, Enron announced that it would take over $1 billion in after-tax write-offs relating to failed investments and a reduction in shareholder equity of $1.2 billion. *Id.* at 636. The next five trading days saw Enron's stock price fall from $33.84 to $19.79. On October 22, Enron announced that the SEC was investigating certain related party transactions, resulting in a further five-day decline to $13.81 per share. On November 8, 2001, Enron announced the need to restate its financial results going back as far as 1997 and conceded that major SPE transactions had been improperly reported. *Id.* Nevertheless, Enron's stock price actually *increased* over the next several days because the company had also announced the prospect of a merger with Dynegy under which shareholders would be paid about $10 per share for their stock. *See id.*; "Enron Admits to Overstating Profits by About $600 Million," *New York Times*, page C1 (November 9, 2001). On November 19, Enron filed a late 10-Q that disclosed a variety of problems relating to the loss of investor confidence and the inability of Enron to obtain credit, and stated that Enron had insufficient cash to make it through the year. Enron's stock price declined from $9.06 to $4.11 during the next five trading days. On November 28, 2001, the failure of the Dynegy merger was announced, causing Enron's share

price to drop from $4.11 to $0.40 over the next five trading days, by which time Enron was in bankruptcy. Enron's stock traded at "salvage" levels – under $1 thereafter.[11]

Thus, by late 2001, the market knew that Enron was a fraudulent company, and the consequences of that fraud – Enron's insolvency – became evident. Nevertheless, because of their complexity and profusion, unraveling all of Enron's fraudulent transactions and discovering the role of each participant required several years and multiple investigations costing more than $100 million. *See, e.g.*, "Enron Bankruptcy Examiner's Fees Soar," *Washington Post*, page E1 (December 30, 2003).

The Enron scheme unquestionably caused losses to the plaintiff class. Defendants' concerted effort to misrepresent Enron's financial condition and create a false appearance of growth caused the market price of Enron stocks and bonds to be artificially inflated far above the true value of the company throughout the class period. Investors who bought shares at inflated prices and held them through Enron's collapse incurred an out-of-pocket loss caused by the fraud. For purchasers who sold prior to bankruptcy, the existence of loss causation (and the calculation of their damages) will require comparison of the amount of inflation at the times of their purchases and sales.

[11] Enron stock price information is available at http://quotes.nasdaq.com/asp/MasterDataEntry.asp?page=Charts.

B. Application of Petitioners' Simplistic Loss Causation Rule to a Complex Fraud Scheme Like Enron's Would Lead to Injustice and Would Undermine Operation of the Securities Laws.

The *Enron* case illustrates how imposing a simplistic "disclosure/price correction" requirement developed in basic misrepresentation cases to complex scheme cases would severely undermine the operation of the securities laws. As this Court has held, section 10(b) covers more than the typical case, and it should not be interpreted in a way that permits perpetrators of unusual frauds to avoid liability. *See Superintendent of Insurance of the State of New York v. Bankers Life and Cas. Co.*, 404 U.S. 6, 10 n.7 (1971).

First, the complexity of the *Enron* facts renders inappropriate and misleading over-reliance on the simplistic paradigm of "misstatement, price increase, disclosure, price drop." In *Enron* there was a profusion of fraudulent transactions and false statements piled one on top of another over an extended period of time, all designed to maintain Enron's inflated stock price. Each quarter, the scheme participants devised new deceptive transactions to maintain the appearance of Enron's prosperity and growth. Any expectation that each individual misstatement or transaction that was part of this deceptive scheme should be accompanied by a discreet price increase reflecting its impact on stock price is naive.

Similarly, the market's recognition of the Enron fraud was far more complex than the paradigm of a single, unambiguous disclosure on which many of the lower-court cases have been based. The dissipation of the dollar amount of artificial inflation that occurred in Enron's stock price in the earlier part of 2001 was not the result of

disclosure of any specific fraudulent transactions but resulted instead from observers raising non-specific questions about Enron's financial strength. Enron and the financial institution analysts sought to minimize these concerns by falsely reassuring the market. These complicating facts confound any expectation that a discreet fraud disclosure should result in a price decline matching the amount of artificial inflation caused by the disclosed fraud. When sufficient elements of the scheme were disclosed in October and November 2001 to cause Enron's stock price to collapse, some portion of the dollar amount of artificial inflation had already been removed from the stock price because of questions that had been raised earlier. Gauging the existence or amount of the loss of those investors who purchased Enron stock at its high-water mark solely on the basis of price declines that occurred when the fraud was explicitly (but only partially) disclosed in late 2001 would ignore relevant facts and understate the investors' true injury.

Second, the *Enron* facts provide a clear example of how artificial inflation may be reduced from the price of a stock without any corresponding price decline. On November 8, 2001, Enron announced that its prior financial statements could no longer be relied upon. Despite this shocking announcement, the price of Enron's stock *rose* slightly over the next several days. Why? Enron simultaneously announced that Dynegy planned to buy Enron at $10 per share, more than the current trading price, thereby buoying Enron's stock price. Petitioner's rule would require that the court and jury look only at the price reaction in the wake of the November 8 disclosure, thereby forcing them to find that the complete falsification of Enron's financial statements from 1997 through 2001 had *no* inflationary impact on Enron's stock price – a facially absurd conclusion.

Third, the Petitioner's proposed rule would assign liability among multiple defendants in a complex fraud case not on the basis of their culpability or the injury their conduct caused investors, but on the basis of each defendant's success in hiding its unlawful conduct. The allegations against Merrill Lynch & Co., Inc. illustrate the point.

On November 3, 2004, four Merrill Lynch executives were convicted of fraud in connection with their role in Enron's "purchase" of certain Enron assets – including some Nigerian Barges – conditioned on an oral side agreement under which Enron would later re-purchase the assets at a profit to Merrill. Enron declared a profit from the sham "sale," allowing it to meet market earnings expectations for the quarter ended December 31, 1999. *In re Enron Corp. Securities, Derivative & ERISA Litig.*, 310 F.Supp.2d 819, 829 (S.D. Tex. 2004). Internal Merrill documents "support a strong inference that Merrill Lynch knew the Nigerian barge deal was a phony transaction created to manipulate Enron's income statements in return for Merrill Lynch's lucrative 15% return." *Id.* Knowing that Enron's earnings numbers were phony, Merrill permitted its securities analysts to issue glowing reports to the public about the company and its prospects. *See id.* at 830. Merrill has executed a letter agreement with the Department of Justice in which it agreed to accept responsibility for the transaction. *Id.* at 829.

The criminal jury specifically found that Merrill's conduct caused a loss to investors. During the late 1990's, failure of growth companies such as Enron to meet analysts' expectations, even by a small amount, usually resulted in a sharp decline in their stock price. *See, e.g.*, Bartholomew, "Is Silence Golden When It Comes to Auditing," 36 J. Marshall L. Rev. 57, 82-83 (2002).

Therefore, Merrill's manipulation of Enron's profit numbers caused Enron's stock price to be higher than it would have been had the market known the truth. Investors who purchased Enron stock in the wake of the phony December 1999 profit announcement paid an inflated price, and those who held the stock until after the Enron bubble burst were unable to recoup their loss. *See In re Enron Securities Litig.*, 310 F.Supp.2d at 832.

Nevertheless, applying the type of loss causation analysis urged by petitioners, Merrill has argued that it should be exempt from liability because the fraudulent transactions in which it participated "were not known to the public until April and August of 2002, respectively, five and nine months after the Class Period ended on November 27, 2001, and long after the price of Enron securities had collapsed." *Id.* at 828 (footnote omitted). In short, Merrill argues that – *even if* it knowingly perpetrated a criminal fraud against investors by scheming to falsify Enron's financial statements and misrepresenting Enron's financial condition in its analyst reports, and *even if* those misrepresentations were material, and *even if* they caused some investors to pay an inflated price for Enron stock, and *even if* those investors were unable to recoup that excess through sale of their stock, thereby realizing a substantial out of pocket loss due to Merrill's fraud – Merrill is immune from liability because it was able to conceal its role in the fraudulent scheme until after the collapse of Enron.

The *Enron* facts illustrate that as increasing information regarding a complex scheme emerges, the market may reach a point – long before all the details have been disclosed – at which it recognizes the inability of the company to sustain operations and the stock price collapses to zero.

Subsequent discovery of additional aspects of the fraud will, of course, have no further price effect. But that does not mean they were immaterial or caused no injury. Whether a particular transaction or participant's role is discovered before or after the "tipping point" may be merely a matter of chance or of the participant's skill in deceiving the market. Petitioners' proposed loss causation standard would establish a "disclosure lottery" in which participants whose injurious, illegal conduct is discovered only after the house of cards collapses are immune from liability, even though they have undoubtedly caused an out of pocket loss to investors. Deserving plaintiffs would be unable to recover from culpable defendants, and some defendants would be required to shoulder a disproportionate share of liability on the basis of chance. Nothing in either the text of purposes of the securities laws supports such an anomalous result.

CONCLUSION

The decision of the Court of Appeals should be affirmed.

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